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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF PETITIONER NEWARK MORNING LEDGER CO.

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QUESTION PRESENTED

Whether the Third Circuit, in acknowledged conflict with other circuits and the United States Tax Court, was correct that under the Internal Revenue Code an income-producing, wasting intangible asset may be nondepreciable "goodwill" as a matter of law.

TABLE OF CONTENTS

PAGE

QUESTION PRESENTED i

TABLE OF AUTHORITIES vi

OPINIONS BELOW 1

JURISDICTION 2

STATUTE AND REGULATION INVOLVED 2

STATEMENT OF THE CASE 3

A. Statement of Facts 3

B. Proceedings Below 6

SUMMARY OF THE ARGUMENT 12

ARGUMENT 14

I. CUSTOMER RELATIONSHIPS THAT HAVE DEFINITE USEFUL LIVES AND ASCERTAINABLE VALUES ARE DEPRECIABLE UNDER SECTION 167 OF THE INTERNAL REVENUE CODE 14

A. The Federal Income Tax Is A Tax On Net Income 15

B. Because Income Tax Is On Net Income, All Wasting Assets Used To Produce Income Are Depreciable 15

1. The Subscriber Relationships Were Found To Be Wasting Assets With Determinable Lives 17

PAGE

2. The Subscriber Relationships Were Property "Used In The Trade Or Business" Or "Held For The Production Of Income" 17

C. "Goodwill" Is Cast As Nondepreciable Under The Treasury Regulation Only Because It Is Not A Wasting Asset With A Determinable Life 19

1. All Intangible Assets With Ascertainable Limited Lives Are Depreciable Under Regulation 1.167(a)-3 19

2. The History Of Regulation 1.167(a)-3 Demonstrates That Goodwill Is Nondepreciable Only Because It Has An Indeterminable Life 21

3. Goodwill Has Always Been A Fluctuating Concept With No Independent Force Under Regulation 1.167(a)-3 25

4. The Government's Refusal To Adhere To The Principle That An Indeterminable Life Is The Hallmark Of Goodwill Has Permitted It To Take Positions Inconsistent With Its Own Revenue Rulings 27

D. The Concept Of Goodwill Must Be Confined To Non-Wasting Assets To Ensure That Income Tax Is A Tax Only On Net Income 29

E. Ledger Did Not Depreciate Customer-Based Intangibles With Indeterminable Lives Or Non-Ascertainable Values 31

PAGE

II. DISALLOWING THE DEPRECIATION OF AN INTANGIBLE ASSET WITH A DETERMINABLE LIFE AND AN ASCERTAINABLE VALUE WOULD UPSET SETTLED EXPECTATIONS AND RESULT IN THE DIFFERENTIAL TREATMENT OF SIMILARLY SITUATED TAXPAYERS 32

A. Since At Least 1973, Taxpayers Could Reasonably Expect That Customer-Based Intangible Assets Proven To Have Determinable Lives And Ascertainable Values Would Be Depreciable Under Section 167. 33

B. Denying The Depreciability Of Wasting Customer-Based Intangible Assets Because They Are At-Will Relationships Or Are Sold As Part Of An Ongoing Business Results In The Differential Tax Treatment Of Similarly Situated Taxpayers 38

1. The Distinction Between Fixed-Term And At-Will Customer Relationships Improperly Exalts Form Over Substance And Produces Inequality 39

2. Whether An Asset Is Sold Separately Or As Part Of An Ongoing Business Has No Bearing On Whether The Asset Is Wasting And Depreciable..... 42

3. Many Indisputably Depreciable Intangible Assets Contain An Element Of Continued Patronage 44

III. THE DEPRECIABILITY OF A WASTING ASSET DOES NOT TURN ON THE METHOD BY WHICH IT IS VALUED..... 45

PAGE

A. The Third Circuit Misconceived The Assets The Taxpayer Sought To Depreciate 46

B. The Income Method Was A Proper Method Of Valuation..... 48

CONCLUSION 50

TABLE OF AUTHORITIES

Cases — PAGE

Aaron E. Levine & Co., Inc. v. *Calkraft Paper Co.*, 429 F. Supp. 1039 (E.D. Mich. 1976) 40

Abco Oil Corp. v. *Commissioner*, 58 T.C.M. (CCH) 1280 (1990) 46

AmSouth Bancorporation and Subsidiaries v. *United States*, 681 F. Supp. 698 (N.D. Ala. 1988) 37

Bell v. *Speed Queen*, 407 F.2d 1022 (7th Cir. 1969) .. 40

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Cohan v. *Commissioner*, 39 F.2d 540 (2d Cir. 1930) . 46

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PAGE

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INDOPCO, Inc. v. *Commissioner*, 112 S. Ct. 1039 (1992) 15

IT&S of Iowa, Inc. v. *Commissioner*, 97 T.C. 496 (1991) 36, 41

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PAGE

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Manhattan Co. of Virginia, Inc. v. *Commissioner*, 50 T.C. 78 (1968).....16, 25, 46, 48

Massey Motors, Inc. v. *United States*, 364 U.S. 92 (1960) 16

Meredith Broadcasting Co. v. *United States*, 405 F.2d 1214 (Ct. Cl. 1969)..... 43

Metropolitan Bank v. *St. Louis Dispatch Co.*, 149 U.S. 436 (1893).....25, 26

Miami Valley Broadcasting Corp. v. *United States*, 499 F.2d 677 (Ct. Cl. 1974)..... 48

Montgomery Coca-Cola Bottling Co., Inc. v. *United States*, 615 F.2d 1318 (Ct. Cl. 1980) 26

National Service Industries, Inc. v. *United States*, 379 F. Supp. 831 (N.D. Ga. 1973).....32, 35

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PAGE

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PAGE

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26 U.S.C. § 162 (1988 & Supp. I 1989) 15

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26 U.S.C. § 1001 (1988) 16

26 U.S.C. § 1016 (1988 & Supp. I 1989) 16, 19

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26 U.S.C. § 7805 (1988) 20

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17 C.F.R. § 210.9-04 ¶ 14(c) (1991) 30

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PAGE

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Rev. Rul. 68-636, 1968-2 C.B. 92..... 28

Rev. Rul. 74-456, 1974-2 C.B. 65.....28, 34

T.B.R. 44, 1 C.B. 133 (1919) 22

T.D. 2929, 1 C.B. 133 (1919) 23

T.D. 4055, VI-2 C.B. 63 (1927) 24

Accounting Authorities

Accounting Standards, Current Text General Standards § I60.101 (Financial Accounting Standards Bd. 1991) 30

PAGE

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1 Accounting Standards Original Pronouncements 467, Accounting Principles Board Opinion No. 17 ¶ 1 (Financial Accounting Standards Board 1970) 30

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PAGE

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NEWARK MORNING LEDGER CO.,
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Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF PETITIONER NEWARK MORNING LEDGER CO.

Petitioner Newark Morning Ledger Co. respectfully requests that the judgment of the United States Court of Appeals for the Third Circuit (the "Third Circuit") be reversed for the reasons set forth herein.

OPINIONS BELOW

The opinion of the Third Circuit (Pet. App. at 1a-30a), as amended, is reported at 945 F.2d 555 (3rd Cir. 1991). The opinion of the United States District Court for the District of New Jersey (Pet. App. at 31a-51a) is reported at 734 F. Supp. 176 (D.N.J. 1990).

JURISDICTION

The judgment of the Third Circuit was entered on September 12, 1991. Rehearing *en banc* was denied (Circuit Judges Greenberg and Nygaard dissenting) on October 15, 1991. (Pet. App. at 52a-53a.) The Third Circuit stayed its mandate on November 14, 1991. The Petition for a Writ of Certiorari was filed on January 13, 1992, and was granted on April 6, 1992. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTE AND REGULATION INVOLVED

Section 167 of the Internal Revenue Code states in relevant part:

> (a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.
>
> . . . .

26 U.S.C. § 167(a) (1988).

The Treasury regulation interpreting section 167(a) states in relevant part:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

Treas. Reg. § 1.167(a)-3 (as amended in 1960).

STATEMENT OF THE CASE

Our federal income tax system has long recognized the right of a taxpayer to depreciate intangible assets that are useful in its business for a limited period of time. Prior to the decision of the Third Circuit in this case, courts uniformly allowed a taxpayer to depreciate its customer-based intangible assets so long as it established that the assets had limited useful lives, which could be estimated with reasonable accuracy, and ascertainable values separate from the residual goodwill value. The trial court in this case found that petitioner fully satisfied this factual showing.[1] The Third Circuit, however, created a contrary new rule of law: that at-will customer relationships acquired as part of an ongoing business are nondepreciable "goodwill." The Third Circuit's new rule of law is now before this Court.

A. Statement of Facts[2]

Petitioner Newark Morning Ledger Co. ("Ledger") is a newspaper publisher that is the successor to The Herald Company ("Herald"). (Pet. App. at 33a.) In 1976, Herald purchased substantially all the stock of Booth Newspapers, Inc. ("Booth"), a publisher of daily and Sunday paid circulation newspapers in eight Michigan communities. (Pet. App. at 34a.)[3] On May 31, 1977, Booth was merged into Herald. (Pet. App. at 35a.) As a result, Herald was required to allocate its adjusted tax basis in the Booth stock among the individual Booth assets in proportion to their fair market values

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1 Those findings of fact were neither challenged by the government, nor set aside by the Third Circuit, as clearly erroneous.

2 The facts are as found by the district court unless otherwise indicated.

3 The eight Michigan newspapers were the *Ann Arbor News*, *Bay City Times*, *Flint Journal*, *Grand Rapids Press*, *Jackson Citizen Patriot*, *Kalamazoo Gazette*, *Muskegon Chronicle*, and the *Saginaw News*.

as of the date of the merger. (Pet. App. at 35a.)[4] The Booth assets included cash and other financial assets, tangible and intangible property used in the business of the Booth newspapers, and the stock of a wholly-owned subsidiary corporation that published *Parade*, a nationwide Sunday newspaper supplement. (Pet. App. at 36a.)

As the government and Ledger stipulated, on the date of merger the total fair market value of the Booth assets was approximately $314 million. (Pet. App. at 35a.) Herald engaged the services of several experts to assist in determining the fair market value of each item of property. Based on the experts' appraisals and subsequent stipulations of the parties, approximately $224 million of the total fair market value of the assets was allocated among various financial, tangible and other property, and approximately $90 million was allocated to certain intangible property used in publishing the Booth newspapers. (Pet. App. at 36a.) Of the $90 million allocated to that intangible property, Herald allocated approximately $68 million to certain wasting intangible assets consisting of relationships with specific persons who subscribed to the Booth newspapers on the date of acquisition. (Pet. App. at 4a.)[5] The residual $22 million basis was allocated to going-concern value and goodwill. (Pet. App. at 37a.)

As of May 31, 1977, the Booth newspapers had 460,000 paid subscribers, each of whom was identified by name and address on records retained by the newspapers, their agents and/or contractors. (Pet. App. at 38a-39a.) The number of

4 Treasury Regulation § 1.334-1(c)(4)(vi)(b). For tax purposes, the fair market value of an asset is the price at which the asset would change hands between a hypothetical willing buyer and willing seller, neither being under any compulsion to buy or sell, and both parties having reasonable knowledge of relevant facts. Rev. Rul. 59-60, 1959-1 C.B. 237.

5 These subscribers had arranged to have daily and, in most instances, Sunday editions of the newspapers delivered to their homes by mail or by carrier, in consideration of payment of the periodic subscription price. (Pet. App. at 38a.) These subscribers with terminable-at-will contractual relationships are sometimes referred to as "paid subscribers." The term "paid subscribers" is intended to reflect the fact that the customers in question paid for their newspapers, rather than receiving them for free, and that they subscribed to the newspaper, requesting regular delivery, rather than purchasing it on a single copy basis.

paid subscribers was an important factor in Herald's decision to purchase Booth and in its determination of the purchase price for the Booth stock. (J.A. at 170-71.)

Most of the Booth paid subscribers were "seasoned," *i.e.*, subscribers who have taken the paper for a lengthy period of time. (J.A. at 67, 102, 168-69.) Because their purchases are regular and predictable, seasoned subscribers represent a reliable and measurable source of revenue for the newspaper. (J.A. at 108-11, 169.) In addition, because a newspaper's principal economic function is to provide a means for advertisers to convey their messages to prospective customers, the number of seasoned subscribers is of great importance to advertisers, and to the newspaper as well. (J.A. at 120-21, 126-28, 134, 160, 168-70.)[6] Consequently, a newspaper greatly values its seasoned subscribers. (J.A. at 111, 154.) Relationships with such seasoned subscribers are difficult to develop and replace. (Pet. App. at 40a-41a; J.A. at 139-51, 165-66.) A newspaper must make substantial efforts by way of circulation sales programs, market research studies, and product and service improvements to develop new subscribers. (J.A. at 76-78, 139-51, 165-66.)

Beginning in 1977, Herald claimed depreciation deductions under section 167 of the Internal Revenue Code[7] with respect to its paid subscribers. This allowed Herald to match the costs of acquiring the paid subscribers (the portion of the purchase price allocated to those subscribers) with revenues

6 Paid circulation newspapers such as the Booth newspapers have two primary sources of revenue: paid circulation, *i.e.*, sales of the newspaper itself, and sales of advertising. Approximately 80% of the total revenue of the Booth newspapers came from advertising sales. The remaining 20% of total revenue consisted of circulation revenue from the paid subscribers (approximately 85% thereof) and circulation revenue from coin box, newsstand and other sales. (Pet. App. at 37a-38a; J.A. at 75, 133, 170-71.)

Generally, advertisers prefer paid circulation over free circulation (due to the greater likelihood that the recipient will actually read the newspaper and see the advertising) and subscription-based circulation over single copy sales (because demographics and coverage are more easily measurable). (J.A. at 120-21, 134-35, 168.)

7 All citations to the Internal Revenue Code and the Treasury regulations are to the Internal Revenue Code and the regulations in effect during the relevant periods, unless otherwise indicated.

generated by them. Herald did not claim depreciation deductions with respect to intangible assets with indeterminable lives or unascertainable values, such as its relationships with advertisers and newstand purchasers and its reputation.

The Internal Revenue Service ("IRS") disallowed the depreciation deductions claimed for the years 1977 through 1980 with respect to the Booth newspapers' paid subscribers, asserting that those assets were part of goodwill and were, therefore, nondepreciable. Herald paid the additional taxes and interest, and Ledger, as successor to Herald, filed a claim for a refund. When the IRS failed to act on the claim within the Code-prescribed six-month period, Ledger filed suit in the United States District Court for the District of New Jersey to recover taxes and interest erroneously assessed and collected.

B. Proceedings Below

The case was tried to the district court from February 5 through February 8, 1990. Ledger and the government agreed that in order to prevail, Ledger had to establish that the subscriber relationships of the Booth newspapers have limited useful lives, the duration of which could be estimated with reasonable accuracy, and ascertainable values separate and apart from goodwill. (Pet. App. at 32a.)

Ledger presented three witnesses with regard to the first of these issues. Dr. Gerald J. Glasser, a statistician with considerable experience with media issues, described the process whereby, using generally accepted statistical techniques, he was able to estimate with the required accuracy the periods during which the paid subscribers would continue to subscribe, *i.e.*, the periods during which the relationships would be useful in the Booth newspapers' business. (Pet. App. at 41a-42a; J.A. at 60-63, 90-92, 94.) Dr. Christine D. Urban, a newspaper industry consultant specializing in circulation issues, and Mr. Werner Veit, Booth's president, supported Dr. Glasser's testimony in this regard, explaining the manner in which subscribers are lost and describing the considerable efforts involved in gaining new subscribers, thereby demonstrating that the paid subscribers do not simply "self-

regenerate." (Pet. App. at 37a-38a; J.A. at 74-78, 139-51; R. at 494-97.) Dr. Urban and Mr. Veit explained the benefits of acquiring seasoned subscribers, who tend to stay with a newspaper for a lengthy, predictable period, unlike marginal subscribers who are obtained through special promotional offers, but who often terminate their subscriptions after receiving the promotional premium. (J.A. at 150-51, 168-70.) The testimony of Dr. Glasser, Dr. Urban, and Mr. Veit was not contradicted, and the district court made the ultimate findings of fact that the paid subscribers would be useful in Ledger's business for only a limited period of time,[8] and that the useful lives of the paid subscribers were determinable with reasonable accuracy. (Pet. App. at 41a.)[9]

Ledger then presented expert testimony to establish that the paid subscribers of the Booth newspapers are separate from the goodwill of the papers. These expert witnesses offered uncontradicted evidence that the goodwill of the Booth newspapers resides in their reputation, their credibility and standing in the community, the quality of their service, and similar nonwasting or indeterminably lived attributes. (J.A. at 109-11; R. at 457-58.) Unlike the relationships with paid subscribers, the value of these attributes cannot be determined

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8 Specifically, the district court stated:

> It is undisputed that all the paid subscribers of the Booth newspapers as of May 31, 1977 would, at some point in time, no longer be subscribers. . . . Subscribers are lost because of death, relocation, lack of reader time or interest, changing lifestyles, and other factors that are beyond the control of the newspapers. Also, subscribers are lost due to dissatisfaction with the product or service and for various other reasons, including competition from other media sources such as radio, television, magazines and other paid-circulation and/or free distribution newspapers.

(Pet. App. at 40a.) The district court also found that the paid subscribers are not self-regenerating assets, meaning "there is no automatic replacement for a subscriber who terminates his or her subscription." *Id.* These facts distinguish the paid subscribers from goodwill, which "by definition, has an indefinite life . . . ." (Pet. App. at 45a.)

9 These findings, together with the district court's finding that the assets have ascertainable values separate from goodwill, triggered a stipulation of the parties as to the specific useful lives that should be used to depreciate the paid subscribers of each of the papers. (Pet. App. at 39a.)

by any direct measurement. (J.A. at 110-11, 164-65.) As a result, their value is appropriately determined using the residual approach, that is, by deriving the amount left after subtracting from the total purchase price the value of all assets that can be specifically identified and valued. (Pet. App. at 45a.)[10]

Based upon this evidence, the district court found that "[a]lthough newspaper subscribers are under no legal obligation to continue their subscriptions, expert opinion and the evidence presented coupled with common sense and experience leads inescapably to the conclusion that the income derived from such paying subscribers will recur, which, in turn, permits the ascertainment of value separate and apart from goodwill." (Pet. App. at 33a.) As the district court stated, the distinction between nondepreciable goodwill and the depreciable paid subscribers of the Booth newspapers is the distinction between "a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity of future purchases cannot be predicted" and "subscribers who can be predicted to purchase the same item, for the same price on a daily basis." (Pet. App. at 32a-33a.) Further elaborating on this point, the district court stated:

> [P]aid subscribers are distinct from previous customers who may or may not return, who may buy more or less or nothing at all. They are identifiable; how long they will remain as subscribers can be predicted with reasonable accuracy; and their value can be measured with a fair degree of accuracy. It is these unique characteristics which separates them from general goodwill and permits of a separate valuation.

(Pet. App. at 45a.)

Finally, Ledger's expert witnesses established the "fair market value" of the paid subscribers, *i.e.*, the price at which the paid subscribers would change hands between a hypothetical willing buyer and willing seller.[11] Ledger called two valuation experts, Messrs. Roger Grabowski and Larry D. Berkey, who identified the three common valuation methods: the market comparable, replacement cost, and income approaches. (Pet. App. at 42a; J.A. at 95-100, 162.) They then explained that the income method is the most appropriate for valuing the paid subscribers because actual buyers and sellers in fact would use that method in negotiating the price to be paid for customer-based assets of an ongoing business such as the paid subscribers. (Pet. App. at 43a; J.A. at 108, 162.)

The unchallenged testimony of Ledger's expert witnesses established that the market comparable approach could not be used in valuing the paid subscribers because there were insufficient sales of comparable property to form a basis for determining a market value. (Pet. App. at 42a; J.A. at 101, 162.) The cost approach also could not be used because there was insufficient evidence as to the cost of duplicating seasoned contractual relationships similar to those with the paid subscribers of the Booth newspapers. (Pet. App. at 42a-43a; J.A. at 67, 102-04, 121-23, 162.)[12] Accordingly, Ledger's

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10 The government stipulated that the fair market value of the Booth newspapers' goodwill and going concern value would be established using the residual method, *i.e.*, it would constitute the remainder of the total $314 million fair market value after value was allocated to all other tangible and intangible assets. (Pet. App. at 37a.)

11 In valuing the paid subscribers, petitioner examined only relationships with the 460,000 specific persons who were subscribers to the Booth newspapers on May 31, 1977. (J.A. at 54-55, 57-58, 72-73.) Although petitioner hoped that additional persons would subscribe to the papers after the acquisition, petitioner did not take such additional subscribers into account in identifying or valuing the asset. The life and value of the Booth newspapers' paid subscribers were based exclusively on the particular contractual subscriber relationships acquired on May 31, 1977. (J.A. at 112, 166.)

12 The government offered a cost approach valuation that estimated the cost of duplicating a "subscription list." (Pet. App. at 43a.) The government estimated the cost of replacing the physical list of subscribers as if it had been destroyed. (J.A. at 82, 85-86, 175.) It estimated that cost by determining the cost of soliciting an equivalent number of subscribers by means of outside sales organizations. (Pet. App. at 43a.) However, the evidence established that this was not the true cost of the paid subscribers of the Booth newspapers (Pet. App. at 42a-43a; J.A. at 122-23, 151-56, 169-70; R. at 494-97), and the government's witnesses admitted that the costs determined in their approaches were not equivalent to the value of the subscribers. (J.A. at 178-86.) The district court found that the government's witnesses "were unqualified, valued the wrong asset [a customer list as opposed to the paid

experts testified that the only valuation method appropriate for determining the fair market value of intangible assets such as the paid subscribers was the income method. (J.A. at 67-68, 105-06, 124, 129, 162.) The district court found that the income approach best reflects the method that buyers and sellers would utilize to determine the price of the paid subscribers. (Pet. App. at 43a-44a.)

Ledger's experts determined the fair market value of the paid subscribers to be nearly $68 million under the income method. (Pet. App. at 46a-47a.) Using that method, the experts determined the net economic benefit of the paid subscribers by calculating "the present value of the net revenue stream [the paid subscribers] would provide over their limited lives, *i.e.*, the subscription revenue less the cost of collecting that revenue." (Pet. App. at 44a, 46a.) Because all the other costs incurred in producing the newspapers would be incurred even if their circulation was by way of free distribution, the experts concluded that measuring this incremental profit was the best way to determine the fair market value of the paid subscribers. (J.A. at 105-08, 124-30, 135-39, 157-58, 159-60.) One of Ledger's experts, Mr. Berkey, testified further that he had tested and confirmed his valuation conclusion by another income approach in which value was determined by subtracting the relevant share of all costs, including the cost to produce the newspapers, from subscription revenue plus that portion of advertising revenue that was allocable to the paid subscribers. (Pet. App. at 46a; J.A. at 160-61.)[13] The government offered no evidence to challenge the valuation methods applied by Ledger's experts. (Pet. App. at 47a.) Accordingly, finding that Ledger's methodology "was fully in accordance with generally accepted valuation principles," the district court fully credited Ledger's valuation methodology and the

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subscribers] and utilized inappropriate methodology," and that the government's method "totally ignores the substantial efforts and expenses that had been invested over the years in establishing those subscriber relationships." (Pet. App. at 43a.) The district court therefore rejected the government's cost approach valuation.

13 This second approach is similar to that used by the taxpayer in *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987).

$68 million fair market value of the paid subscribers. (Pet. App. at 44a-45a, 47a.)

Thus, the district court found as fact that Ledger's terminable-at-will contractual relationships with its subscribers have limited useful lives, the duration of which was estimated with reasonable accuracy, and ascertainable values separate and apart from goodwill. (Pet. App. at 50a.) Based on these factual findings, the district court concluded that Ledger is entitled to claim depreciation deductions with respect to the paid subscribers. (Pet. App. at 50a.)

On appeal, faced with Ledger's unchallenged proof as to the wasting lives and separate values of the paid subscribers, the government argued that because the value of the Booth newspapers' relationships with its paid subscribers is based on the continued patronage of those subscribers, and because customer patronage is the essence of nondepreciable goodwill, the paid subscribers are part of goodwill and, as such, are nondepreciable. (Pet. App. at 7a.) In short, the government urged that a *per se* rule be grafted onto the provisions of section 167 of the Internal Revenue Code and section 1.167(a)-3 of the Treasury regulations that would deny depreciation for numerous wasting assets. Under the government's broad *per se* rule, any at-will customer-based intangible asset acquired as part of an ongoing business is nondepreciable.

The Third Circuit accepted the government's argument and, on September 12, 1991, reversed the decision of the district court. While the court of appeals accepted the trial court's factual findings that the paid subscribers have limited useful lives and ascertainable values (Pet. App. at 9a), it nevertheless held that the paid subscribers are not depreciable. (Pet. App. at 29a.) The Third Circuit concluded that, notwithstanding the unchallenged factual findings of the district court, Ledger *could not* have met its burden of proof, since the value of the paid subscribers acquired as part of an ongoing business was goodwill as a matter of law. (Pet. App. at 29a-30a.)

The Third Circuit placed decisional weight on the fact that the relationships between the Booth newspapers and their

subscribers are based in terminable-at-will contracts rather than contracts with fixed terms. (Pet. App. at 11a-12a.) The court held that patronage embodied in fixed-term contracts is not goodwill, and observed that "if the subscribers were contractually obligated to continue subscribing for some period of time, Ledger clearly would be permitted to depreciate the value of those contracts over that time period." (Pet. App. at 11a-12a.)

On October 15, 1991, the Third Circuit denied Ledger's petition for rehearing and suggestion for rehearing *en banc*. Two Circuit Judges, Greenburg and Nygaard, dissented. On April 6, 1992, this Court granted *certiorari*.

SUMMARY OF THE ARGUMENT

The income tax is a tax on *net* income. Taxable net income is determined by subtracting from revenues the expenses of producing those revenues. The expense of wasting business assets is taken into account by depreciating them over their useful lives. Thus, section 167 of the Internal Revenue Code ("Code") requires that there "shall be allowed . . . a depreciation deduction" for all wasting assets, tangible and intangible, that are used in a business or held to produce income. The assets in question here—Ledger's relationships with its subscribers—were found as fact by the district court to meet the statutory requirements for depreciability. Those facts were accepted by the Third Circuit.

Treasury Regulation 1.167(a)-3 ("regulation 1.167(a)-3"), which interprets section 167, expressly provides that an intangible asset with a life that "can be estimated with reasonable accuracy" is depreciable. The regulation disallows depreciation of "[a]n intangible asset, the useful life of which is not limited." "Goodwill" is identified as nondepreciable because it has an indeterminable life. Consistent with the statute, the regulation thus provides that whether an intangible asset may be depreciated depends entirely on whether its useful life can be estimated with reasonable accuracy. It is undisputed that the lives of Ledger's purchased subscriber relationships can be—and were—so determined.

The Third Circuit abandoned the unambiguous statutory and regulatory command that a wasting asset "shall be" depreciable. Instead, the court adopted a definitional approach to goodwill that imbued a traditional *description* of goodwill—"the expectancy that old customers will resort to the old place"—with a talismanic substantive force superior to the clear mandate of section 167. As a result, the court abandoned the statutory and regulatory criteria for depreciability and adopted a new *per se* rule: at-will subscriber relationships (and other such intangible customer-based assets) purchased as part of an ongoing business may not be depreciated even though their lives can be "estimated with reasonable accuracy."

This holding not only constitutes judicial rewriting of the tax law but is bound to cause unadministrable confusion. No one can be sure what assets may now be held to create the "expectancy" the court has substituted for the analytical approach of the statute and regulation. Goodwill is not a concept with a fixed content. It is a residual concept—the value that remains after the identifiable assets with determinable lives have been valued and subtracted from the price paid for a business. The only thing consistent about goodwill, until the Third Circuit's decision, is that it has an indeterminable life. That is goodwill's defining characteristic and, as the history of the regulation demonstrates, that is the only reason goodwill is not depreciable. Ledger's subscriber relationships do not share the defining characteristic of goodwill.

At least since the Fifth Circuit's seminal decision in *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), a decision that caused the government to abandon its prior position that all customer-based intangible assets were nondepreciable, taxpayers have acquired businesses with the reasonable expectation that such assets, with proven limited lives and ascertainable values, could be depreciated. Those settled expectations have now been upset. Worse, the Third Circuit's new rule would treat economically identical customer-based intangible assets differently by making wholly arbitrary distinctions between assets embodied in fixed-term rather than at-will contracts, between assets acquired separately rather

than as part of an ongoing business, and between assets valued pursuant to one commonly accepted valuation method as opposed to another.

These distinctions have nothing to do with the principles of economics or accounting, nor should they be arbitrarily thrust into the tax law. Such distinctions, as the government will surely concede, have nothing to do with the depreciability of tangible assets under section 167. Since section 167 treats tangible and intangible assets alike, these new and capricious Third Circuit distinctions may not determine whether intangible assets are depreciable.

ARGUMENT

I.

CUSTOMER RELATIONSHIPS THAT HAVE DEFINITE USEFUL LIVES AND ASCERTAINABLE VALUES ARE DEPRECIABLE UNDER SECTION 167 OF THE INTERNAL REVENUE CODE

In acquiring the Booth newspapers, Ledger paid $68 million for extremely valuable but wasting assets—the Booth newspapers' long-standing relationships with their subscribers. Those relationships have useful lives whose lengths were determined and whose values were ascertained. The district court so found, and the Third Circuit did not disturb those factual findings.

Given these facts, Ledger has the right, under section 167 of the Code, to depreciate those wasting assets so that the revenues generated by them are offset by Ledger's tax basis in acquiring them. This matching of gross revenue and costs to arrive at taxable net income is a fundamental principle of tax law. This case is controlled by that principle; its application to the undisputed facts requires reversal of the judgment below.

A. The Federal Income Tax Is A Tax On Net Income

It is a fundamental premise of the Internal Revenue Code that the income tax is a tax on net—not gross—income. This principle has long been axiomatic in the drafting and structure of the income tax laws. In furtherance of the goal of taxing only net income, Congress has incorporated into the income tax laws the concept of "matching" annual income with the annual expenses incurred to earn that income. This matching is necessary to achieve the accurate determination—and taxation—of net income.[14] As this Court recently stated, "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *INDOPCO, Inc.* v. *Commissioner*, 112 S. Ct. 1039, 1043 (1992).

B. Because Income Tax Is On Net Income, All Wasting Assets Used To Produce Income Are Depreciable

Section 167 is one of the principal provisions by which the Code matches income against expenses. It provides:

> There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income.[15]

Section 167 provides for the depreciation of a wasting asset over the useful life of the asset. *See INDOPCO*, 112 S.Ct. at

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14 The matching principle is explicitly embodied in Code sections 162 (deduction of ordinary and necessary business expenses), 167 and 168 (depreciation of capitalized costs), 441 (providing that taxable income shall be computed on the basis of a taxpayer's taxable year), 446 (method of accounting), 451 (taxable year for recognition of income), and 461 (taxable year for deductions).

15 The tax laws have included a deduction for depreciation of wasting assets since the first modern income tax statute. The listed deductions in the Act of 1913 included "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business. . . ." Act of October 3, 1913, Sec. II(B). Section II(G)(b) provided a similar deduction for corporate taxpayers.

1042 ("a capital expenditure usually is amortized and depreciated over the life of the relevant asset"). Were such depreciation deductions not allowed, a taxpayer would be taxed on more than net income because the full costs of producing the taxpayer's revenues in a given year would not be taken into account. *See Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960) ("It was the design of Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets [that are wasting] . . . ."); *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101 (1943) ("the machine in its lifetime must pay for itself before it can be said to pay anything to its owner").

Section 167 does not vest the IRS with discretion to disallow a depreciation deduction for wasting assets. To the contrary, the provision is mandatory, and directs that a depreciation deduction "shall be allowed" with respect to wasting property used in a business. *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d 128, 131-32 (8th Cir. 1960).[16]

Nor is section 167 limited to particular types of property. Instead, the provision applies to all property "used in the trade or business" or "held for the production of income." Such property includes both tangible and intangible assets. *Northern Natural Gas*, 277 F.2d at 131; *Manhattan Co. of Virginia, Inc.* v. *Commissioner*, 50 T.C. 78, 91 (1968).[17] In

16 Depreciation is also mandatory for the taxpayer. Code section 1016(a)(2) states that a taxpayer's cost basis is reduced by the amount of the greater of depreciation deductions allowed or "allowable." Thus, a taxpayer "entitled" to depreciate an asset *must* depreciate the asset, or face the unpleasant consequences when the asset is later sold and it is taxed as if it had properly depreciated the asset. That is, a taxpayer who fails to take depreciation deductions will nonetheless be forced by Code sections 1001 and 1016 to report gain on the difference between the selling price and the lower tax basis that it would have had in the asset if the proper depreciation deductions had been taken.

17 The government, in its rulings, has also recognized that there is no distinction between intangible and tangible property for purposes of depreciation. Rev. Rul. 68-483, 1968-2 C.B. 91-92, *modified*, Rev. Rul. 75-137, 1975-1 C.B. 74 ("Whether or not an intangible asset, or a tangible asset, is depreciable for Federal income tax purposes depends upon the determination that the asset is actually exhausting, and that such exhaustion is susceptible of measurement.").

sum, in order to effectuate the Code's basic goal of taxing only net income, *all* wasting assets used in a business are depreciable over the course of their useful lives.

1. The Subscriber Relationships Were Found To Be Wasting Assets With Determinable Lives

Based upon the testimony of expert statistician Dr. Gerald J. Glasser, other testimonial evidence regarding the limited lives of the subscribers, and the stipulation of the parties as to the limited lives for depreciation purposes if the district court found the assets were depreciable,[18] the district court found:

> Either based upon the inevitable death of the *subscribers* or the statistical evidence submitted by plaintiff and the uncontroverted expert opinions that the *subscriptions* have limited useful lives which can be estimated with reasonable accuracy, plaintiff has clearly established that the paying subscribers (or subscriptions) of the acquired newspapers had limited useful lives, the duration of which can be and has been estimated with reasonable accuracy.

(Pet. App. at 32a) (emphasis in original). This finding has never been contested by the government and was not upset by the Third Circuit on appeal.

2. The Subscriber Relationships Were Property "Used In The Trade Or Business" Or "Held For The Production Of Income"

Section 167 allows the depreciation of any wasting asset (1) "used in the trade or business" *or* (2) "held for the production of income." This broad language clearly includes the

18 Ledger and the government stipulated to specific separate useful lives for both the daily subscriber relationships and the Sunday subscriber relationships for each of the eight Booth newspapers. The lives of these 16 distinct groups of subscriber relationships ranged from a low of 14.7 years for both the daily and Sunday subscribers to the *Ann Arbor News* to a high of 23.4 years for the Sunday subscribers to the *Bay City Times*. (Pet. App. at 39a.)

subscriber relationships at issue here. Indeed, the government never asserted that the assets were not so used or so held.

First, the subscriber relationships are "used in the trade or business" because they are critical to the attraction of advertisers. Advertising revenues constitute approximately 80% of the total revenue of the Booth newspapers. (Pet. App. at 7a n.2, 38a.) Advertisers purchase advertising on a cost per thousand basis, so that a larger subscriber base generates higher advertising rates and greater revenues. (J.A. at 134-35.) Moreover, advertisers generally prefer paid circulation over free circulation (because of the greater likelihood that the recipient will actually read the newspaper and see the advertising), and subscription-based circulation over single copy sales (because demographics and coverage are more easily measurable). (J.A. at 120-21, 134-35, 168.) Thus, the subscriber relationships are a key asset "used in the trade or business" to attract advertisers. *See Donrey, Inc.* v. *United States*, 809 F.2d 534, 536 (8th Cir. 1987) (subscriber relationships are used in a newspaper business as "an indispensable tool in selling advertising"; asset held depreciable).

Second, the subscriber relationships are clearly "property held for the production of income." The 20% of Booth newspaper revenue not derived from advertising was derived from circulation. (Pet. App. at 37a-38a; J.A. at 75, 133, 170-71.) Approximately 85% of this circulation revenue was from subscribers; the remainder came from single copy sales. Thus, the subscribers produce income—and the subscriber relationships are business property held to produce income—within the meaning of section 167(a).

Though the Third Circuit accepted that the subscriber relationships were wasting, income-producing assets used in Ledger's trade or business, it held that the relationships were "goodwill" and thus not depreciable as a matter of law under regulation 1.167(a)-3. In denying the depreciation of a wasting asset, the Third Circuit ignored the dictates of section 167, misconstrued the Treasury regulation, and abandoned the fundamental precept that federal income taxation is a tax on net income.

C. "Goodwill" Is Cast As Nondepreciable Under The Treasury Regulation Only Because It Is Not A Wasting Asset With A Determinable Life

The Third Circuit's decision was based on a basic misconception as to the nature of "goodwill" for income tax purposes and the reason why it is described as nondepreciable under regulation 1.167(a)-3. Properly understood, goodwill is not a substantive concept that overrides the plain language of section 167 and renders nondepreciable certain wasting business assets with proven ascertainable lives. Instead, it is a residual concept that encompasses certain *non*wasting and indeterminably lived aspects of a business that remain after all identifiable tangible and intangible assets are valued. *See* Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 Harv. L. Rev. 859, 861 (1968) (goodwill is "the residual intangible asset"); McDonald, *Goodwill and the Federal Income Tax*, 45 Va. L. Rev. 645, 648 (1959) (goodwill is "the indefinable something left over"); Gen. Couns. Mem. 35,535 (October 30, 1973) ("we note the tendency to define goodwill in negative terms").[19]

1. All Intangible Assets With Ascertainable Limited Lives Are Depreciable Under Regulation 1.167(a)-3

The circumstances under which intangible assets are depreciable under section 167 are addressed by regulation 1.167(a)-3. Specifically, that regulation provides for the depreciation of an intangible asset if it is "of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy"; sets forth patents and copyrights as examples of depreciable intangible

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19 Indeed, recent statutory and regulatory provisions expressly recognize that goodwill is not amenable to specific identification and valuation, but instead represents the residual value of an ongoing business over and above the fair market value of all identifiable assets—both tangible and intangible. *See* 26 U.S.C. § 1060; 26 C.F.R. §§ 1.338(b)-2T(b)(2), 1.1060-1T(d). These provisions codify the government's longstanding preference for using the residual method to value goodwill. *See* S. Rep. No. 313, 99th Cong, 2d Sess. 252 (1986). In this case, the government "stipulate[d] the residual method is the proper method" to value goodwill. (J.A. at 164-65.)

assets; provides for no depreciation of "[a]n intangible asset, the useful life of which is not limited"; and provides that "[n]o deduction for depreciation is allowable with respect to goodwill." Given section 167's overriding mandate that there "shall" be a depreciation deduction for all wasting business assets, the only permissible reading of regulation 1.167(a)-3 is that all assets with limited lives, "the length of which can be estimated with reasonable accuracy" (like patents and copyrights) are depreciable, and all assets whose "useful life . . . is not limited" (like goodwill) are not depreciable. Thus, the statement that goodwill is nondepreciable is not a substantive principle of law, but is merely an example of the proposition that an intangible asset without a limited life cannot be depreciated.[20] Indeed, Congress has repeatedly stated that it is only "because goodwill does not have a determinable useful life . . . [that] no depreciation deduction is allowed." H.R. Rep. No. 495, 100th Cong., 1st Sess. 936 (1987).[21]

The government and the Third Circuit lost sight of the congressional rationale codified in section 167, which controls the meaning of regulation 1.167(a)-3. The government argued, and the Third Circuit agreed, that goodwill is a substantive concept, the essence of which is "the expectancy that old customers will resort to the old place," and that an asset

20 To the extent that regulation 1.167(a)-3 purported to render nondepreciable a wasting asset properly depreciable under section 167 of the Code, it would be invalid. Section 1.167(a)-3 was promulgated pursuant to the Treasury Department's general authority under section 7805(a) of the Code to "prescribe all needful rules and regulations." Section 7805(a) is not a grant of substantive rulemaking authority or "a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision." *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 24-25 (1982) (*quoting Rowan Cos.* v. *United States*, 452 U.S. 247, 253 (1981)). Rather, it is merely an "interpretive" regulation and, as such, regulation 1.167(a)-3 cannot establish more stringent conditions for depreciation of intangible assets than those imposed by the clear language of the statute. *See Northern Natural Gas*, 277 F.2d at 133-35.

21 *See also* S. Rep. No. 144, 97th Cong., 1st Sess. 39 (1981) ("Land, goodwill, stock, and other assets that do not have a determinable useful life and that do not decline in value predictably are not depreciable."); H.R. Rep. No. 215, 97th Cong., 1st Sess. 206 (1981) ("Assets that do not decline in value on a predictable basis or that do not have a determinable useful life, such as land, goodwill and stock, are not depreciable.").

tinged with this expectancy is nondepreciable notwithstanding proof that the asset is wasting and has a determinable life. This reading of the regulation is not only at odds with the express terms of section 167, but is belied by the plain language of the regulation, the focus of which is the asset's wasting nature. Moreover, the notion that goodwill has any fixed substance—let alone a substantive force sufficient to render nondepreciable a wasting asset—is simply wrong. The only rationale for casting goodwill as an example of a nondepreciable intangible asset under regulation 1.167(a)-3 and its predecessor Treasury regulations is that goodwill was believed not to waste or to have a determinable life.

2. The History Of Regulation 1.167(a)-3 Demonstrates That Goodwill Is Nondepreciable Only Because It Has An Indeterminable Life

As noted above, under regulation 1.167(a)-3 all assets with proven determinable lives are depreciable and those with indeterminable lives are not depreciable; goodwill is not depreciable *because* it does not have a determinable life. This is evident from the history of regulation 1.167(a)-3.

The first set of official Treasury regulations that expressly provided for the depreciation of intangible assets was adopted in 1919. Regulations 45, T.D. 2831, Art. 163 (1919). Article 163 stated:

> Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. *If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance*, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. There can be no such allowance in

> respect of good will, trade names, trademarks, trade brands, secret formulae or processes.

Id. (emphasis added). Thus, intangible assets with limited lives (for example, patents and copyrights) were depreciable; intangible assets with indeterminable lives (for example, goodwill and trademarks) were not. Critically, the taxpayer was permitted to depreciate intangibles "known from experience to be of value in the business for only a limited period." The decisive inquiry was expressly made to turn on whether a given intangible asset had a limited life—demonstrated by a prescribed statutory period or by "experience."

Shortly after promulgation of Article 163, the Advisory Tax Board addressed the depreciability of goodwill in light of the passage of the Prohibition Amendment to the Constitution. T.B.R. 44, 1 C.B. 133, 134-135 (1919). Prohibition raised the prospect that the goodwill of an alcohol-related business might have a determinable life. Accordingly, while the Board acknowledged that, as a general matter, goodwill has no limited life, it recognized that the controlling principle for depreciation was whether the asset was *actually* wasting:

> [Article 163 of Regulations 45] states that "Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance." It is true that this same article states that no such allowance may be made in the case of intangibles of the class now under consideration [including goodwill], and while in general this negative decision is sound, *the controlling rule is the one quoted above, and when an item of intangible property falls within that rule it must be dealt with accordingly. [That is the] major rule laid down in [the regulation].*
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> * * *
>
> *[W]hen it is demonstrated that the useful life of an intangible is definitely limited, such intangible then becomes a proper subject of depreciation allowance.*

Id. (emphasis added). Thus, the Board concluded that in limited circumstances, such as where an alcohol-producing business was to cease operations as a result of Prohibition,

goodwill might have an ascertainable, limited life so that a depreciation deduction for goodwill might be warranted. *Id.* The Treasury Department contemporaneously modified Article 163, and deleted the last sentence which stated, "[t]here can be no such [depreciation] allowance in respect of good will, trade names, trademarks, trade brands, secret formulae, or processes." T.D. 2929, 1 C.B. 133 (1919). Over the next several years, the Treasury Department expressly recognized that, in rare circumstances such as Prohibition, where the taxpayer could demonstrate that goodwill had a determinable life, it was, like all other intangible assets, depreciable.[22]

In 1927, relying on accounting principles, the Eighth Circuit noted in *Red Wing Malting Co.* v. *Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927):

> [Goodwill's] actual value changes from day to day and there would be so much uncertainty in any attempt to adjust its book value that by common consent it is left alone. . . . *As good will does not suffer wear and tear, does not become obsolescent, is not used up in the operation of the business, depreciation, as such, cannot be charged against it.*

Id. at 633 (quoting *Montgomery's Auditing Theory and Practice*) (emphasis added). Thus, the Eighth Circuit held that "[w]e are satisfied there can be no wear or tear of goodwill, or exhaustion thereof by use . . . ." *Id.*[23] Thereafter, the

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22 *See, e.g.*, O.D. 818, 4 C.B. 178 (1921) (goodwill and other intangibles with definitely limited lives because of Prohibition were depreciable; goodwill was not depreciable if the alcohol dealer continued in a similar trade or business, since goodwill would still have an unlimited life); O.D. 472, 2 C.B. 141 (1920) (goodwill was depreciable if the taxpayer could show that the business' goodwill would have no value at the end of a definite period because the business was forcefully terminated). Indeed, no less a jurist than Learned Hand twice ruled that goodwill was a depreciable intangible asset when proven to be wasting or obsolete. *See Williams* v. *McGowan*, 152 F.2d 570, 572 (2d Cir. 1945); *Haberle Crystal Springs Brewing Co.* v. *Clarke*, 30 F.2d 219, 222 (2d Cir. 1929), *rev'd on other grounds*, 280 U.S. 384 (1930).

23 The underlying issue in *Red Wing* was whether a business that discontinued its operations as a result of Prohibition was entitled to an obsoles-

Treasury Department changed its position by expressly adopting the *Red Wing* ruling, and amended the regulations interpreting the depreciation statute by adding the concluding sentence: "No deduction for depreciation, including obsolescence, is allowable in respect of goodwill." T.D. 4055, VI-2 C.B. 63 (1927). The Treasury regulations interpreting the depreciation statute have included such a provision ever since.

As the above history demonstrates, goodwill was cited as nondepreciable under the regulations only because it was believed not to waste. When it appeared that, due to the unusual circumstance of Prohibition, the goodwill of some alcohol-related businesses might actually have a determinable life, the regulation was amended to allow for the depreciation of goodwill. It was only after the Eighth Circuit held that goodwill had an indeterminable life for all businesses, regardless of Prohibition, that goodwill was again cast as nondepreciable in the regulations.[24]

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cence deduction under the predecessor to section 167 with respect to the goodwill lost upon such discontinuance. The court held that the allowance for obsolescence was limited to those assets that were subject to wear and tear on the date of purchase. Accordingly, having concluded that goodwill does not normally suffer wear or tear, no obsolescence deduction was permitted.

24 For the next sixty years, courts continued to adhere to the view that goodwill was nondepreciable solely because it was presumed not to waste. *See, e.g., Patterson* v. *Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987) (goodwill "does not waste"); *Donrey*, 809 F.2d at 536 ("Goodwill is conclusively presumed to have an unlimited useful life"); *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 450 (Ct. Cl. 1976) ("Goodwill is . . . presumed to have a useful life of indefinite duration"); *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240, 1248 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) (goodwill is "an ongoing asset that fluctuates but does not necessarily diminish"); *Dodge Brothers, Inc.* v. *United States*, 118 F.2d 95, 100 (4th Cir. 1941) (goodwill is not depreciable "because of the manifest difficulties inherent in the computation of both the life span and the value of this intangible asset"); *Landsberger* v. *McLaughlin*, 26 F.2d 77, 78 (9th Cir. 1928) ("we think it clear that goodwill is not . . . subject to exhaustion, wear, or tear"); *Colorado National Bankshares, Inc.* v. *Commissioner*,

3. Goodwill Has Always Been A Fluctuating Concept With No Independent Force Under Regulation 1.167(a)-3

The Third Circuit's position that the subscriber relationships are not depreciable hinges on imbuing the word "goodwill" with a substantive force that is superior to the mandate of section 167. Indeed, the Third Circuit's decision is based entirely on the erroneous premise that a traditional *description* of goodwill—"the expectancy that old customers will resort to the old place"—creates an exception to the plain words of the Code. That remarkable conclusion apparently derives from the fact that this description of goodwill has often been repeated by rote. (Pet. App. at 11a, 16a, 23a-25a.) In fact, "goodwill" has no fixed content, let alone substantive force sufficient to abrogate the basic premise that taxation is imposed only on net income.

The notion that goodwill is the "expectancy that old customers will resort to the old place" was first espoused, not in any tax case, but by Lord Eldon in the 1810 British decision of *Cruttwell* v. *Lye*, 17 Ves. 335, 346 (1810). Because the defendant, who sold his business with its goodwill, had started a competing business at a new location, the court held that he had not appropriated the goodwill he had sold.

This Court also had occasion to grapple with the content of goodwill and, specifically, its application to newspapers in *Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436 (1893). This Court observed:

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60 T.C.M. (CCH) 771, 789 (1990) ("Goodwill, by definition, has an indefinite life . . . ."); *Illinois Cereal Mills, Inc.* v. *Commissioner*, 46 T.C.M. (CCH) 1001, 1023 (1983), *aff'd* 789 F.2d 1234 (7th Cir.), *cert. denied*, 479 U.S. 995 (1986) ("Neither goodwill nor going-concern value is subject to depreciation because the useful life is not susceptible of reasonable estimation"); *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 233 (1975), *acq.*, 65 T.C. 1153 (1976) (goodwill "may be expected to continue indefinitely"); *Manhattan Co. of Virginia Inc.* v. *Commissioner*, 50 T.C. 78, 88 (1968) ("Goodwill has uniformly been held not to be subject to depreciation since it is not generally a wasting asset of the business to which it attaches, but rather an asset with an indefinite useful life").

> Undoubtedly, good will is in many cases a valuable thing, although there is difficulty in deciding accurately what is included under the term.

Id. at 446.

Subsequent to *Metropolitan Bank*, courts and commentators continued to recognize the elusive nature of goodwill. *See, e.g., People ex rel A.J. Johnson Co.* v. *Roberts*, 159 N.Y. 70, 80-81, 53 N.E. 685, 687-689 (1899) (collecting cases and treatises discussing the numerous definitions of goodwill); Wright, *The Nature And Basis Of Legal Goodwill*, 24 Ill. L. Rev. 20, 23-24 (1929) ("With the complex bases upon which goodwill rests, it is self-evident that, if we attempt to reduce goodwill to a simple, well-defined concept, we shall encounter difficulties.").[25]

The "definition" of goodwill which is the foundation of the government's position and the Third Circuit's decision is a misunderstood shibboleth dating back to 1810. While repeated by courts as a convenient, if imprecise, way to describe goodwill, this definition was framed for purposes irrelevant here, does not address the problems of the federal tax laws and is of no analytical use in the present case. In fact, goodwill and future patronage are not synonymous under the Code. Thus, it has been held that an operating business with continued customer patronage may have no goodwill for income tax purposes. *See, e.g., Montgomery Coca-Cola Bottling Co., Inc.* v. *United States*, 615 F.2d 1318, 1331-32 (Ct. Cl. 1980) (no goodwill in business operated pursuant to a franchise); *Zorniger* v. *Commissioner*, 62 T.C. 435, 444-445 (1974) (same); *Pensacola Greyhound Rac-*

25 The Third Circuit also noted (Pet. App. at 10a-11a, n.5) that the absence of a clear definition of goodwill has generated much criticism among the commentators. *See* Mundstock, *Taxation of Business Intangible Capital*, 155 U. Pa. L. Rev. 1178, 1206-07 (1987); Dubin, *Allocation of Costs to and Amortization of Intangibles in Business Acquisitions*, 57 Taxes 930, 933 (1979); Grigsby & Cotter, *Amortization of Certain Intangibles*, 30 U.S.C. Tax Inst. 543, 545 (1978); Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 Tax Law. 251, 258-59 (1975); Frank, *Goodwill Is Not Immortal: A Proposal To Deduct the Exhaustion of Purchased Goodwill*, 23 J. Taxation 380, 380-81 (1965); Note, *An Inquiry Into the Nature of Goodwill*, 53 Colum. L. Rev. 660, 685-86 (1953).

ing, Inc. v. *Commissioner*, 32 T.C.M. (CCH) 1064, 1069 (1973) (no goodwill in monopoly or quasi-monopoly market). Here, of course, the Third Circuit admits that future patronage under fixed-term contracts is not goodwill. (Pet. App. at 112-122.) The only fixed aspect of goodwill that has roots in the federal income tax laws is that goodwill has an indeterminable life.

Unadministrable, vague and descriptive "definitions" of goodwill have no place in the implementation of our nation's revenue laws. They only sow unpredictability and confusion. Moreover, it is not necessary to define goodwill to resolve whether customer-based intangibles are depreciable. Instead, limiting goodwill to the non-wasting, residual attributes of a business is an easily-administered, predictable rule that is in accordance with the express terms of section 167, the underlying principles of the Code and modern-day economic and business realities.

4. The Government's Refusal To Adhere To The Principle That An Indeterminable Life Is The Hallmark Of Goodwill Has Permitted It To Take Positions Inconsistent With Its Own Revenue Rulings

The government has lost sight of the principle that the signature characteristic of goodwill is that it is nonwasting in favor of the amorphous notion that "goodwill is the expectancy that old customers will resort to the old place"—a homily that permits the government to assert that any intangible asset related to patronage is, *per se*, nondepreciable goodwill.[26] This approach ignores the reason why goodwill is

26 To this end, the government has repeatedly attempted to portray goodwill as a sacrosanct concept that taxpayers try to avoid by engaging in "shenanigans" with respect to depreciating wasting intangible assets. For example, in *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990), the government complained that "tax benefits motivated petitioner to allocate as much of the purchase price [of a bank] to deposit base [intangible assets]," which constituted, according to the government, "self-serving accounting shenanigans." *Id.* at 493. The Tax Court resoundingly rejected the government's position, stating that "it is not improper for petitioner to attempt to minimize its tax liability. Respondent's [the government's] argument misses the mark." *Id.*

cast as nondepreciable and has permitted the government to take positions inconsistent with its own revenue rulings.

For example, the government has conceded that customer-based intangible assets, including insurance expirations, customer lists and subscription lists, are not *per se* goodwill, but are instead depreciable, provided the taxpayer can make the requisite factual showing that the assets are wasting and have values separate and distinct from goodwill. Rev. Rul. 74-456, 1974-2 C.B. 65.[27] Although the government has not revoked its rulings, it now urges that a host of customer-based assets be held nondepreciable goodwill as a matter of law.[28]

The government's reliance on hoary descriptions and vague notions that goodwill is connected to patronage, rather than on the regulation-based principle that goodwill is nonwasting, has resulted in the inconsistent treatment of wasting intangible assets. While the government may consistently quote its "old customers returning to the old place" standard, the government clearly has not consistently applied that standard to various classes of intangible assets.[29] The proper inquiry under section 167 is *not* whether the asset is somehow con-

27 The government has been equally inconsistent with its treatment of other wasting intangible assets under the depreciation statute, including covenants not to compete and fixed-term contracts. *See, e.g., U.S. Industrial Alcohol Co.* v. *Commissioner*, 42 B.T.A. 1323, 1344-45 (1940), *aff'd in part and rev'd in part*, 137 F.2d 511 (2d Cir. 1943) (contrary to its position in this case, government argued fixed-term contract was goodwill); Rev. Rul. 68-636, 1968-2 C.B. 92 (government reversed its position and conceded that covenents not to compete are not *per se* goodwill).

28 Because of the inconsistencies in the government's legal position, the government's interpretation of section 167 and regulation 1.167(a)-3 is not entitled to deference from this Court. *See, e.g., Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. 272, 279 (1966) ("[t]he Commissioner's position represents a sudden and unwarranted volte-face from a consistent administrative and judicial practice"); *Transco Exploration Co.* v. *Commissioner*, 949 F.2d 837, 840 (5th Cir. 1992) (the Commissioner "ought to do more than stride to the dais and simply argue in the opposite direction").

29 In fact, in *Concord Control, Inc.* v. *Commissioner*, 615 F.2d 1153 (6th Cir. 1980), when the Tax Court found that a business had no goodwill pursuant to that very standard, the government argued on appeal that "the Tax Court committed an error of law by requiring an expectancy of continued customer patronage or competitive advantage . . . to establish the existence of goodwill." *Id.* at 1155.

nected to patronage, but rather, whether the asset is proven to be wasting. This is true with respect to *all* assets. The government's continued reliance on "old customers returning to the old place" simply affords it the opportunity to deny depreciation deductions for certain wasting assets—assets which *must* be depreciated pursuant to section 167 of the Code.

D. The Concept Of Goodwill Must Be Confined To Non-Wasting Assets To Ensure That Income Tax Is A Tax Only On Net Income

The government's position that some wasting assets related to patronage are not depreciable is flatly inconsistent with generally accepted accounting principles. Those principles require that the cost of identifiable assets shall *not* be included in goodwill, but separately accounted for. Accounting Standards, Current Text General Standards ("ASCT") § 160.107 (Financial Accounting Standards Bd. 1991); 1 Accounting Standards Original Pronouncements 467, Accounting Principles Board Opinion No. 17 ("APB Op. No. 17") ¶ 26 (Financial Accounting Standards Bd. 1970). They further require that the costs of identifiable intangible assets be depreciated by systematic charges against income over the periods estimated to be benefited. ASCT at § 160.108.

From an accounting standpoint, therefore, the government's position that identifiable, wasting assets are not depreciable if they relate to patronage results in a clear overstatement of a taxpayer's net income.[30] Disallowing the depreciation of such assets prevents the taxpayer from

30 It is no answer that assets misidentified as goodwill are deductible at the termination or sale of the business. Because of the time value of money, a deduction allowed in the year when the cost is incurred is worth far more than one allowed years later.

To make the point in mathematical terms, the present value of $1 million depreciated over 20 years @10% is $212,839 (assuming a tax rate of 50%). In contrast, the present value of a $1 million deduction that can be taken 20 years later is $74,322—only 35% of the amount depreciated over 20 years. This is precisely why, from an economic standpoint as well as a tax standpoint, each tax year must stand on its own.

deducting costs incurred during certain years to produce income from the income produced during those years. In contrast, allowing the depreciation of identifiable, wasting customer-based intangible assets, such as the subscriber relationships here, furthers the accounting goal of accurately reflecting—and the tax goal of only taxing—net income. *See Northern Natural Gas*, 277 F.2d at 140 (Blackmun, J. concurring) (depreciation deduction for proven wasting asset "seems to me to coincide with good business practice and good accounting."). Petitioner agrees that our tax laws treat goodwill as nonwasting and hence nondepreciable. However, because this principle is contrary to economic and accounting principles, it is especially important that the tax concept of goodwill *not* be expanded to make clearly wasting assets nondepreciable.[31]

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31 Accounting principles hold that goodwill is an intangible asset comprising "the cost of an acquired enterprise over the sum of identifiable net assets." ASCT §§ I60.101, I60.401; APB Op. No. 17 ¶ 1. Its life cannot be estimated reliably either at the date of acquisition or thereafter. APB Op. No. 17 ¶ 16. Assets acquired prior to November 1, 1970 are depreciated as long as they have a determinable life. Assets acquired after that date are depreciated using the best estimation of their useful life, with a maximum life of 40 years to be applied to any asset—*including goodwill*—estimated to have a life longer than 40 years. ASCT §§ I60.102, I60.110. This reflects a 1970 amendment that was based on the conclusion that the value of goodwill almost inevitably becomes zero at some future date. APB Op. No. 17 ¶ 23. The United States General Accounting Office agrees:

> The current tax treatment of goodwill and similar intangible assets fails to recognize the economic benefits that wasting intangible assets contribute over time. These assets are consumed over time even if a precise period cannot be determined. Denying amortization deductions does not result in an accurate determination of taxable income since expenses are not properly matched to income generated.

GAO Report (GAO/GGD-91-88), *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment Of Intangible Assets* (Aug. 1991) at 5.

Citing the necessity of accurately portraying economic reality, the depreciability of goodwill has also been recognized in the federal regulatory context. 17 C.F.R. § 210.9-04 ¶ 14(c); *see also* Staff Accounting Bulletin Nos. 42 & 42A, Fed. Sec. L. Rep. (CCH) ¶ 74,111 at 64,222 (May 3, 1989); *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 15 (1974) ("Although agency-imposed compulsory accounting practices do not necessarily dictate tax consequences [citation omitted], they are not irrelevant and may be accorded some significance.").

E. Ledger Did Not Depreciate Customer-Based Intangibles With Indeterminable Lives Or Non-Ascertainable Values

Consistent with the principle that only intangible assets with determinable lives are depreciable, Ledger did *not* depreciate two of its three basic customer relationships—its advertisers and its newsstand purchasers—because they had no ascertainable lives or values. Those customers differ from Ledger's subscribers in that they must make daily, affirmative decisions to continue patronizing the newspaper.[32] Their values and lives are uncertain and, as such, the advertiser and newsstand purchaser relationships were treated as part of Ledger's nondepreciable $22 million goodwill/going concern value.[33]

As the district court correctly held, the distinction Ledger drew between its depreciable subscriber relationships and its nondepreciable advertiser and newsstand purchaser relationships was correct:

> one must distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can purchase the same item, for the same price on a daily basis. Although newspaper subscribers are under no legal obligation to

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32 *See Colorado National*, 60 T.C.M. (CCH) at 789 ("The value of the deposit base rests upon the ascertainable probability that inertia will cause depositors to leave their funds on deposit for predictable periods of time.").

33 The government contends that to allow the depreciation of the subscriber relationships here will lead to the depreciation of all types of customer relationships, for "an expert could no doubt be found to conclude that some specific percentage of a particular grocery store's customers" have a determinable life. (Br. U.S. at 11 n.7.) As this case demonstrates, however, not all customer relationships can be shown to have determinable lives *and* values, as were the subscriber relationships here. Even assuming that the government's hypothetical grocery store customers could be shown to have determinable lives, they could not be valued because their purchases—unlike the inertia-based, constant quantity consumption of the subscribers here—will vary constantly. Moreover, the government's argument assumes—incorrectly—that factfinders are incapable of making determinations on ascertainable lives and values. To the contrary, they have been doing so ever since the adoption of the income tax laws, and there is no reason to assume that they cannot continue to do so in the future.

> continue their subscriptions, expert opinion and the evidence presented coupled with common sense and experience leads to the inescapable conclusion that the income derived from such paying subscribers will recur, which, in turn, permits the ascertainment of value separate and apart from goodwill. The income derived from the subscribers permits the calculation of value over the useful lives of the subscriptions or subscribers, and renders the subscribers acquired subject to valuation as an asset separate and apart from goodwill.

(Pet. App. at 32a-33a.)

II.

DISALLOWING THE DEPRECIATION OF AN INTANGIBLE ASSET WITH A DETERMINABLE LIFE AND AN ASCERTAINABLE VALUE WOULD UPSET SETTLED EXPECTATIONS AND RESULT IN THE DIFFERENTIAL TREATMENT OF SIMILARLY SITUATED TAXPAYERS

Taxpayers should be entitled to structure their business transactions based on settled expectations of the tax consequences. *United States* v. *Byrum*, 408 U.S. 125, 134 (1972). Moreover, taxpayers are entitled to expect that the revenue laws be enforced in a uniform fashion. *Portland Golf Club* v. *Commissioner*, 110 S. Ct. 2780, 2789 (1990). The Third Circuit's decision violates both of these principles.

First, the Third Circuit's holding—that some assets with wasting lives and ascertainable values are not depreciable if they are related to future patronage—marks a significant departure from two decades of rulings, which focus on the "economic reality" of the asset and the business. Consistent with section 167, this "economic reality" approach focuses not on an asset's connection to patronage, but on the asset's wasting nature. Thus, taxpayers have had good reason to expect that a customer-based intangible was depreciable if the taxpayer could "show with reasonable accuracy, but without exactitude, the value of the intangible asset and its useful life." *National Service Industries, Inc.* v. *United States*, 379

F. Supp. 831, 833 (N.D. Ga. 1973). The *per se* rule adopted by the Third Circuit is completely at odds with this approach.

Second, the qualifications relied upon by the Third Circuit to limit its aberrational holding—that the subscriber relationships were not embodied in fixed-term contracts and were sold as part of an ongoing business—bear no relationship to whether an asset is wasting. To allow the depreciation of some wasting customer-based assets but deny it for others results in the differential treatment of similarly situated taxpayers.

A. Since At Least 1973, Taxpayers Could Reasonably Expect That Customer-Based Intangible Assets Proven To Have Determinable Lives And Ascertainable Values Would Be Depreciable Under Section 167

Historically, the government has sought to establish that a host of intangible assets connected to patronage were goodwill as a matter of law. *See supra* pp. 27-29. Often, because the taxpayer was unable to meet its burden of demonstrating the asset's determinable life, the government prevailed. *See Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240, 1245-46 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).[34] However, beginning in the 1960's, taxpayers were increasingly able to establish that customer-based intangible assets, in fact, had determinable lives; and though similar assets may have been found nondepreciable in the past, courts permitted their depreciation because taxpayers were able to meet their burden of proof that the asset wasted.[35]

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34 Reviewing prior case law, the court noted that where "the limited and ascertainable lives of the intangibles had been proven by sufficient competent evidence," the taxpayer was allowed to depreciate the customer-based asset. *Id.* at 1249. In contrast, where the taxpayer had failed to carry its burden and did not establish that the asset had a limited life—so that the asset was in the "nature of goodwill"—the asset was held nondepreciable. *Id.*

35 *See, e.g.*, *Super Food Services, Inc.* v. *United States*, 416 F.2d 1236 (7th Cir. 1969) (at-will franchise contracts); *Commissioner* v. *Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966) (at-will loan accounts); *First Pennsylvania Banking & Trust Co.* v. *Commissioner*, 56 T.C. 677 (1971) (at-will depositor contracts).

In the landmark decision of *Houston Chronicle*, the Fifth Circuit expressly held that a subscription list, regardless of its connection to future patronage, was *not* part of the residual goodwill value as a matter of law. *Id.* at 1251.[36] Crystallizing the prior case law, *Houston Chronicle* rejected any suggestion that customer-based intangible assets are *per se* nondepreciable and established a two-pronged test to determine whether an intangible asset may be depreciated. It held that an intangible asset was depreciable if the taxpayer could demonstrate that the asset has (i) an ascertainable value separate and distinct from goodwill; and (ii) a limited useful life, the duration of which can be ascertained with reasonable accuracy. *Id.* at 1251. The *Houston Chronicle* court concluded:

> As the concurring opinion of then-Circuit Judge Blackmun makes clear, if the asset is shown to be a wasting one used in the taxpayer's trade or business, a reasonable deduction must be allowed.

Id. at 1251 (citing *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d 128, 139-41 (8th Cir. 1960) (Blackmun, J., concurring)).

As a result of *Houston Chronicle*, the IRS conceded that customer-based intangible assets—such as subscription lists, insurance expirations and customer lists—would no longer be treated as *per se* goodwill. Rev. Rul. 74-456, 1974-2 C.B. 65-66. Rather, provided the taxpayer could meet the two-pronged *Houston Chronicle* test, a depreciation deduction would be allowed.[37]

Houston Chronicle marked a turning point in the treatment of customer-based intangible assets. Following the lead of the Fifth Circuit, courts focused on the actual economic characteristics of the asset; if the acquired customer-based intangible asset was proven to have a determinable life and an

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36 Although *Houston Chronicle* did not involve the purchase of an ongoing business, this is not a meaningful distinction. *See infra* pp. 42-44.

37 Nevertheless, the government seized upon the *Houston Chronicle* language "value separate and distinct from goodwill" and argued, inconsistent with its ruling, that customer-based intangibles were not depreciable because they have no value separate and distinct from goodwill. *See supra* p. 28.

ascertainable value, it was depreciable. The anachronistic "old customers returning to the old place" was no longer tolerated as the dispositive litmus test to determine whether an asset should be depreciated. *See, e.g., Houston Chronicle*, 481 F.2d at 1253-54 ("Our view—that amortizability for tax purposes must turn on factual bases—is more in accord with the realities of modern business . . ."); *National Service*, 379 F. Supp. at 834 ("The modern trend of authorities . . . favors the test of 'economic reality' [to determine whether an asset is depreciable]"). So far as Ledger is aware, since *Houston Chronicle*, no court (other than the Third Circuit in this case) has ever held a customer-based intangible asset nondepreciable when a determinable life and ascertainable value were established.

For example, in *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446 (Ct. Cl. 1976), the taxpayer purchased an ongoing insurance business. When the taxpayer sought to depreciate 1,383 insurance expirations (customer information files), the government disallowed the deduction on the ground that the assets were an inextricable part of the business' goodwill. The court held that the proper focus for determining depreciability is not whether the assets technically fall within the amorphous concept of goodwill, but whether the assets, like patents and copyrights and unlike goodwill, have determinable lives and ascertainable values. *Id.* at 452. The court thus found that "[a]n intangible asset is separate and distinct from goodwill when its useful life can be shown with reasonable accuracy to be of limited duration." *Id.* at 454. Accordingly, because the taxpayer proved that the insurance expirations had limited lives of approximately five years (*id.* at 454-56), it was entitled to depreciate those customer-based intangible assets regardless of their connection to future patronage.

In *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987), the taxpayer purchased an ongoing newspaper business and sought to depreciate the newspaper's subscriber relationships. The government disallowed the deduction. At trial, the taxpayer proved that the subscriber relationships had average determinable lives of 23 years. *Id.* at 535. Based on the use of the subscription structure as "an indispensable tool in sell-

ing advertising," the taxpayer also established that the asset's value was derived, in part, from its ability to attract advertising revenues, and not solely from the expectation that it would provide future customers of the business. *Id.* at 536.[38] Accordingly, the Eighth Circuit held that the subscriber relationships acquired by the taxpayer were depreciable intangible assets, and were not goodwill.

In *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990), the taxpayer acquired nine operating banks. When the taxpayer sought to depreciate the bank's core deposit accounts (customer bank accounts), the government disallowed the deduction. While the government maintained that the core deposit accounts were simply customer relationships, the taxpayer demonstrated that the core deposit accounts had determinable lives and ascertainable values due to their use in the business as a "low-cost source of funds." *Id.* at 489.[39] Thus, the court held that the customer-based intangible assets were depreciable.

In sum, since *Houston Chronicle*, courts have consistently declined the government's repeated invitations to "inquire into the intrinsic nature of the [customer-based] asset measured and determine whether it is, in essence, goodwill." *Col-*

38 The government has tried to distinguish *Donrey* from this case on the ground that "the taxpayer [in *Donrey*] made an effort to identify its written 'subscription list' as an asset separate and apart from its continuing non-contractual relationships with its subscribers." (Br. U.S. at 12.) The government's distinction is incorrect. The taxpayer in *Donrey*, as Ledger sought to do in this case, depreciated the subscriber relationships. In fact, the Tax Court has expressly rejected the government's attempt to recast the depreciated asset in *Donrey* as a subscription list. *See Citizens & Southern Co.* v. *Commissioner*, 91 T.C. 463, 487 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

39 The Tax Court subsequently reaffirmed the *Citizens & Southern* holding in *Colorado National Bankshares, Inc.* v. *Commissioner*, 60 T.C.M. 771 (1990), and *IT&S of Iowa, Inc.* v. *Commissioner*, 97 T.C. 496 (1991)—both of which allowed the depreciation of at-will customer-based intangible assets acquired as part of the purchase of an ongoing business. It is well-settled that decisions of the Tax Court should be accorded deference in deciding federal tax cases in recognition of its expertise in the implementation of the income tax laws. *Dobson* v. *Commissioner*, 320 U.S. 489, 502 (1943).

orado National, 60 T.C.M. (CCH) at 789. Instead, recognizing that the most fundamental criterion for a depreciation deduction is whether the asset is wasting, courts have permitted depreciation provided that the taxpayer can demonstrate, as petitioner did here, that the asset is identifiable, has a limited life and is capable of valuation.[40] Whatever "residual" value is left after all identifiable assets, including intangibles with determinable lives, are valued, is goodwill for income tax purposes.[41] As the Tax Court succinctly explained:

> Goodwill, by definition, has an indefinite life, and is valued using the residual method. By contrast, the [customer-based intangible] deposit accounts of the acquired banks could be, and were, identified; had limited lives that could be estimated with reasonable accuracy . . . and could be, and have been, valued directly with a fair degree of accuracy. Moreover, petitioner's deposit accounts were not self-regenerating. [Citation

40 *See generally* cases cited *supra* at pp. 32-38; *see also Los Angeles Central Animal Hospital, Inc.* v. *Commissioner*, 68 T.C. 269 (1977); *Business Service Industries, Inc.* v. *Commissioner*, 51 T.C.M. (CCH) 539 (1986).

41 While the Third Circuit acknowledged that there was substantial case law adopting this view, it erroneously concluded that these cases "represent no more than a minority strand amid the phalanx of cases that have considered the definition and application of the term 'goodwill' in the context of § 1.167(a)-3, and which support the Service's position." (Pet. App. at 23a.) The Third Circuit is wrong. As one commentator observed after exhaustively analyzing the case law:

> Judge Becker's opinion in *Newark* paints a completely misleading picture of the case law, and . . . his statement that the 'overwhelming weight of authority' is with the IRS is only true if one counts the cases without paying any attention to developments over time.

Avi-Yonah, *Newark Morning Ledger: A Threat to the Amortizability of Acquired Intangibles*, 55 Tax Notes 981, 984 (1992).

In fact, the only post-*Houston Chronicle* cases relied upon by the Third Circuit that arguably question the residual approach to goodwill are *General Television, Inc.* v. *United States*, 449 F. Supp. 609 (D. Minn. 1977), *aff'd*, 598 F.2d 1148 (8th Cir. 1979), and *AmSouth Bancorporation and Subsidiaries* v. *United States*, 681 F. Supp. 698 (N.D. Ala. 1988), both of which have been seriously called into question by the subsequent holdings of the Eighth Circuit in *Donrey* and the Eleventh Circuit in *Citizens & Southern*. (*See supra* pp. 35-36.)

omitted]. Therefore, the deposit accounts were assets with values separate and apart from goodwill. It is these characteristics which separate them from general goodwill and permits separate valuations.

Colorado National, 60 T.C.M. (CCH) at 789.[42]

B. Denying The Depreciability Of Wasting Customer-Based Intangible Assets Because They Are At-Will Relationships Or Are Sold As Part Of An Ongoing Business Results In The Differential Tax Treatment Of Similarly Situated Taxpayers

In implementing the tax laws, the government must treat similarly situated taxpayers equally. *See, e.g., Sirbo Holdings, Inc.* v. *Commissioner*, 476 F.2d 981, 987 (2d Cir. 1973); *International Business Machines Corp.* v. *United States*, 343 F.2d 914, 920 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966). Notwithstanding this principle, the government seeks to enforce regulation 1.167(a)-3 in a manner that would allow certain taxpayers to depreciate wasting customer-based intangible assets and disallow others the same right based upon two arbitrary distinctions: whether the assets constitute fixed-term or at-will relationships; and whether the assets were acquired separately or as part of an ongoing business. Moreover, the government concedes that certain wasting assets

42 In 1987, a bill was proposed in Congress to amend section 167 and make all customer-based intangible assets nondepreciable. The proposed bill provided, in relevant part:

> *Treatment of Customer Base Intangibles and Similar Items.*—For purposes of determining whether any amount paid or incurred to acquire customer base, market share, or any similar intangible item is allowable as a deduction under this section [167] or any other provision of this title, such amount shall be treated as paid or incurred for intangible property with an indeterminable useful life . . . .

H.R. 3545, 100th Cong., 1st Sess., § 10120 (1987). Thus, the bill would have rendered customer-based intangibles nondepreciable by statutorily bestowing upon them the signal quality that renders goodwill nondepreciable—"an indeterminable useful life." Although the bill was enacted as Title X of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987), Congress declined to adopt the provision denying depreciation of customer-based intangibles. In effect, Congress refused to adopt the position that the government takes here.

used to attract future patronage are depreciable, yet refuses to accord the same treatment to the subscriber relationships here, despite the fact that they are used to attract advertising patronage. None of these distinctions relates to the only relevant inquiry under section 167—whether the assets are wasting—and each is an improper basis upon which to differentiate between taxpayers.

1. The Distinction Between Fixed-Term And At-Will Customer Relationships Improperly Exalts Form Over Substance And Produces Inequality

Although the government at one time maintained that customer relationships embodied in fixed-term contracts constituted goodwill,[43] it now concedes that such patronage is depreciable because of its ascertainable limited life. As the Third Circuit noted in this case:

> the Service does not dispute[ ] that the value of the paid subscribers would not constitute goodwill if Morning Ledger's "expectation of continued patronage" were contractually-based. [citation omitted] Thus, if the subscribers were contractually obligated to continue subscribing for some period of time, Morning Ledger clearly would be permitted to depreciate the value of those contracts over that time period. In such an event, continued patronage would not be a "mere expectation," but a contractual right, and hence not goodwill.

(Pet. App. at 11a-12a.)

Yet patronage stemming from at-will contractual relationships is also more than a "mere expectation" where the taxpayer can identify its customers and prove, as Ledger did, a duration and value for the relationships.[44] Although the use-

43 The government previously claimed that a fixed-term contract represented goodwill because, after the contract expired, the business may well continue to enjoy the benefits of the customer's patronage. *See, e.g., U.S. Industrial Alcohol Co.* v. *Commissioner*, 42 B.T.A. 1323, 1344-45 (1940), *aff'd in part and rev'd in part*, 137 F.2d 511 (2d Cir. 1943).

44 Contrary to the government's suggestion (Br. U.S. at 8 n.6), the subscriber relationships at issue here are contractually-based. When a subscrip-

ful life of a fixed-term customer relationship is expressly stated and the useful life of a terminable-at-will customer relationship is determined by "experience or other factors," regulation 1.167(a)-3 explicitly makes this distinction irrelevant for depreciation purposes. Thus, under § 1.167(a)-3, an at-will customer relationship with a proven, five-year useful life is indistinguishable for depreciation purposes from a customer relationship having a fixed term of five years. Both have a value to the business and will be useful in the business for only five years.

The income tax laws do not exalt form over substance. *See Gregory* v. *Helvering*, 293 U.S. 465, 470 (1935). Applying this principle, this Court held that the same tax treatment must be accorded to a terminable-at-will mining lease and a fixed-term mining lease because the economic realities of the relationship, not the technical form of the lease agreement, properly govern an asset's depreciability under the income tax laws. *United States* v. *Swank*, 451 U.S. 571, 585 (1981). Similarly, prior to the Third Circuit's decision, it was widely accepted that a distinction between fixed-term and at-will customer relationships under section 167 impermissibly exalted form over substance.

In *Super Food Services, Inc.* v. *United States*, 416 F.2d 1236 (7th Cir. 1969), for example, the taxpayer acquired a grocery store chain, including its terminable-at-will franchise contracts. At trial, the taxpayer proved that these customer

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tion is taken, the newspaper agrees to deliver an edition every day and the customer agrees to pay as long as delivery is made. The fact that the customer has the right to cancel the subscription does not make the ongoing relationship non-contractual; until he cancels, the subscriber is contractually obligated to pay. *See, e.g., Landess* v. *Borden, Inc.*, 667 F.2d 628, 631 (7th Cir. 1981) (oral agreements of indefinite duration to collect milk from farmers and deliver it to dairy were implied contracts that were terminable-at-will); *Bell* v. *Speed Queen*, 407 F.2d 1022, 1024 (7th Cir. 1969) (oral agreement for wholesale distributorship franchise that was indefinite as to time and territory was a contract providing continuing performance that was terminable-at-will by either party); *Aaron E. Levine & Co., Inc.* v. *Calkraft Paper Co.*, 429 F. Supp. 1039, 1050 (E.D. Mich. 1976) (oral distributor agreement that contained no express provision regarding duration was a contract terminable at will by either party).

relationships had an average life of seven years. Rejecting the government's attempt to draw a distinction based on the form, rather than the substance, of the relationship, the Seventh Circuit held that:

> neither the statute nor the regulations establish such an inflexible standard. The appropriate test is whether the particular taxpayer has adequately demonstrated that in his business the useful life of the challenged intangibles may be reasonably approximated. [Citations omitted] It is immaterial that the contracts may have no fixed termination date.

Id. at 1240.

Similarly, in *IT&S of Iowa, Inc.* v. *Commissioner*, 97 T.C. 496 (1991), the taxpayer acquired a bank and sought to depreciate the core deposit accounts. As in *Super Food Services*, the government argued that, because the deposit relationships were terminable-at-will, they represented "nothing more than the expected value of future patronage or renewal of previous business, or simply goodwill." The Tax Court flatly rejected the government's argument, holding:

> The fact that a deposit account has no fixed termination date and is terminable at will does not as a matter of law prevent petitioner from factually showing that the deposit base has an ascertainable cost basis separate and distinct from goodwill.

Id. at 509 (quoting *Citizens & Southern*, 91 T.C. at 486).

In essence, the government seeks to establish a new rule that a taxpayer can establish the limited life of a customer-based asset only by embodying it in a fixed-term contract. Such a rule directly conflicts with regulation 1.167(a)-3, which allows a limited life to be established "from experience or other factors," and finds no support in section 167 or—aside from the Third Circuit's decision—the case law. Rather, the income tax laws do *not* exalt form over substance but look to the economic realities of a transaction. Accordingly, until the Third Circuit's decision, depreciation deductions

have been allowed for at-will customer relationships just as they have for fixed-term customer relationships.[45]

2. Whether An Asset Is Sold Separately Or As Part Of An Ongoing Business Has No Bearing On Whether The Asset Is Wasting And Depreciable

In an attempt to distance this case from the holding in *Houston Chronicle*—where a subscription list was found *not* to be goodwill as a matter of law—the government seeks to draw a distinction between a customer-based intangible asset acquired separately and one acquired as part of an ongoing business.[46] According to the government, the former is not *per se* goodwill, the latter is. (Pet. App. at 17a.) Neither the statute nor the Treasury regulations distinguish between assets purchased separately and those acquired as part of an ongoing business.

No court (other than the Third Circuit) has ever denied a depreciation deduction for a wasting intangible asset on the ground that it was acquired as part of an ongoing business. In fact, courts have expressly refused to do so. For example, in *Super Food Services*, the Seventh Circuit stated:

> In our view . . . it is also immaterial whether these [at-will] contracts were acquired separately or as part of a going business. Any quarrel with the going concern value of contracts acquired as part of a business is properly directed to the allocation to be made between goodwill and the contracts purchased and should not be

45 *See, e.g., Donrey*, 809 F.2d at 534; *Super Food Services*, 416 F.2d 1236; *Citizens & Southern*, 91 T.C. 463; *IT&S*, 97 T.C. 496; *Colorado National*, 60 T.C.M. (CCH) 771; *Business Services Industries*, 51 T.C.M. (CCH) 539; *First Pennsylvania*, 56 T.C. 677 (1971).

46 The government's present position—that a subscription list acquired in isolation is *not per se* goodwill—is directly contrary to its position in the *Houston Chronicle* case, where the government vigorously argued that the subscription list's connection to future patronage rendered it goodwill as a matter of law. Moreover, the government's characterization of the asset acquired in *Houston Chronicle* as solely a subscription list is misleading. (Pet. App. at 17a.) In fact, the taxpayer in *Houston Chronicle* acquired a host of intangible and tangible assets, including the seller's goodwill, to which a $775,400 residual value was allocated. 481 F.2d at 1244.

> relied on as requiring a complete denial of depreciation deduction to contracts shown to have a limited useful life.

416 F.2d at 1240.

In *Laird* v. *United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978), the taxpayer purchased a professional football franchise and sought to depreciate the players' contracts. As in this case, where the government maintained that the value of the subscriber relationships was inextricably "bound up" with the value of goodwill (Pet. App. at 17a), the government in *Laird* argued that the value of the player contracts was part of an acquired "bundle-of-rights," which could not be disentangled from the business' goodwill value. The Fifth Circuit rejected the government's argument:

> The proposition that the individual assets sought to be amortized have no value except in the context of the entire bundle of rights and assets is at odds with [prior decisions] . . . . It does not matter for purposes of amortization if individual assets only have economic significance in the context of an integrated transaction involving the sale of a number of assets . . . . That the assets contribute value to one another does not prevent their severability for tax purposes.

Id. at 1234; *see also KFOX, Inc.* v. *United States*, 510 F.2d 1365, 1377 (Ct. Cl. 1975) ("[personal] service contracts . . . may be divisible from 'goodwill' and other intangibles and be treated separately for tax purposes."); *Meredith Broadcasting Co.* v. *United States*, 405 F.2d 1214, 1225 (Ct. Cl. 1969) ("the aggregate intangible value of a going business is composed of separate intangible assets which may be separately identified, valued and treated for federal tax purposes, regardless of what terminology [to define goodwill] may be employed.").

In seeking to draw a distinction between assets acquired separately and assets acquired as part of an ongoing business, the government again ignores the purpose of depreciation deductions—to compensate for the wasting nature of certain

assets in order to ensure a tax on net income. In determining whether an asset has a limited life, it is simply irrelevant whether it is sold as part of an ongoing business or sold individually. It is indisputable that a *tangible* asset's depreciability does not turn on whether it was acquired separately or as part of an ongoing business, but rather on whether the tangible asset has a limited life. So too, a customer-based intangible asset does not become nondepreciable because it is sold as part of an ongoing business. As the court in *Super Food* correctly observed, the fact that a customer-based intangible is sold as part of an ongoing business goes only to the "allocation to be made" between the asset and goodwill; it cannot support "a complete denial of depreciation deduction to [at-will] contracts shown to have a limited life." 416 F.2d at 1240. As a result, courts have uniformly allowed the depreciation of customer-based intangibles with limited lives transferred as part of an ongoing business.[47]

3. Many Indisputably Depreciable Intangible Assets Contain An Element Of Continued Patronage

A wasting asset with a determinable life and an ascertainable value is not rendered nondepreciable simply because it contains an element of expected future patronage. *See Richard S. Miller*, 537 F.2d at 450 ("Where the useful life of an intangible readily can be shown to be limited, such as with a patent or a copyright, depreciation is available without question even though for some purposes it is an element of goodwill."); *Colorado National*, 60 T.C.M. at 790 (same). As the government concedes, a fixed-term contract is depreciable even though it may do nothing more than require the buyer to patronize the seller. Subscription lists purchased separately are depreciable, even though they are essentially the right to solicit and receive future patronage from the seller's customers. Even patents, which are cited as an example of depreciable intangible assets under regulation 1.167(a)-3, may

47 *See, e.g., Donrey*, 809 F.2d 534; *Richard S. Miller & Sons*, 537 F.2d 446; *Super Food Services*, 416 F.2d 1236; *Seaboard Finance Company*, 367 F.2d 646; *IT&S*, 97 T.C. 496; *Citizens & Southern*, 91 T.C. 463; *Colorado National*, 60 T.C.M. (CCH) 771; *Los Angeles Central Animal Hospital*, 68 T.C. 269; *First Pennsylvania Banking*, 56 T.C. 677.

amount to little more than the right to receive continued patronage if, for example, the patent holder simply licenses the patent instead of utilizing it himself. In sum, there simply is "no authority for the proposition that assets, intangible or tangible, are not separate and distinct from goodwill unless no part of their value is related to continued patronage of customers of an ongoing business." *Citizens & Southern*, 91 T.C. at 515 (Cohen, J. concurring); *accord Seaboard Finance Company*, 367 F.2d at 651.[48]

III.

THE DEPRECIABILITY OF A WASTING ASSET DOES NOT TURN ON THE METHOD BY WHICH IT IS VALUED

The Third Circuit erroneously held that Ledger's subscriber relationships are *per se* nondepreciable goodwill, and thus did not have to decide which valuation method was appropriate in this case. Nevertheless, it implied that if Ledger valued the intangible assets pursuant to the cost method (the cost of generating similar seasoned subscribers), rather than the income method (the economic benefit to be generated by the subscribers over their remaining useful lives), the assets might have been depreciable. The Third Circuit's apparent rejection of the income method finds no support in the Code, the reg-

48 Even if the embodiment of continued patronage were sufficient to render a wasting asset nondepreciable, the subscriber relationships at issue here would still be depreciable. The subscriber relationships were not valuable solely because of the future subscription fees they would yield. A critical attribute of the subscriber relationships, ignored by the government and the Third Circuit below, is that they are *the* critical asset for generating advertising revenues, and advertising revenues constitute *80%* of the total revenues of the Booth newspapers. (Pet. App. 37a-38a; J.A. at 75, 133, 170-71.) The subscriber relationships were thus valuable not only for the direct patronage that flowed from them, but as an asset used for the attraction of advertisers. *See Donrey*, 809 F.2d at 536. In fact, one of Ledger's experts performed a valuation study of the subscriber relationships taking into account the enhanced advertising revenues and arrived at a value which closely approximated the value ultimately adopted by the district court. (Pet. App. at 46a; J.A. at 160-61.)

ulations, the case law, or commercial practice and should be rejected.[49]

A. The Third Circuit Misconceived The Assets The Taxpayer Sought To Depreciate

The Third Circuit's analysis is muddled by its misperception of the assets that Ledger has sought to depreciate, and upon which the experts offered evidence relating to fair market value. Using the same faulty reasoning applied by the government's discredited experts, the Third Circuit assumed that the assets being valued here—the subscriber relationships—were the same as an asset denominated a "subscription list." The Third Circuit noted with disapproval that Ledger was not "satisfied" to seek a depreciation allowance for its subscription list valued on a cost basis, which the court suggested may have been acceptable. (Pet. App. at 30a.) Although the cost approach might have been an appropriate valuation method for a "subscription list," that fact would determine neither the correct valuation method for the paid subscribers, nor whether the latter assets are depreciable—an issue that turns wholly on whether the subscriber relationships have determinable lives and ascertainable values.

The Third Circuit inaccurately stated that the government "offered expert testimony that the 460,000 subscribers to the Booth newspapers could be valued on a cost basis at roughly $3 million, whereas Morning Ledger's experts valued the same subscribers on an income basis at over $67 million!" (Pet. App. at 29a.) That conclusion is totally at odds with

49 Contrary to the Third Circuit's suggestion that an asset is wholly nondepreciable if the court determines that the allocation between the value of goodwill and an intangible asset is incorrect, courts are required to make the proper allocation in recognition of section 167's command that there be a "reasonable allowance" for depreciation and the fundamental tax principle that an estimated deduction is preferable to no deduction at all. *See, e.g., Seaboard Finance Company*, 367 F.2d at 651; *Cohan* v. *Commissioner*, 39 F.2d 540, 544 (2d Cir. 1930); *Abco Oil Corp.* v. *Commissioner*, 58 T.C.M. (CCH) 1280, 1282 (1990); *Citizens & Southern*, 91 T.C. at 495; *Manhattan Co. of Virginia, Inc.* v. *Commissioner*, 50 T.C. 78, 91 (1968).

every piece of evidence presented at trial and with the uncontested factual findings of the district court.

The government's experts never testified that the 460,000 subscribers acquired by Herald on May 31, 1977, "could be valued on a cost basis at roughly $3 million." Rather, they testified that the *information* contained on a tangible list of the names of those subscribers might be recreated for approximately that amount. (J.A. at 82, 85-86, 175.) Both of the government's experts unequivocally stated that the asset they valued (subscription list) was different from the 460,000 subscriber relationships. (J.A. at 175, 185.)[50] Moreover, both experts conceded that the cost method they used would not properly value the subscriber relationships because it would attribute the greatest value to the least valuable subscriber relationships, and the lowest value to the most valuable relationships—those with "seasoned subscribers." (J.A. at 178-86.)[51] As the district court found, the cost approach did not recognize "the substantial efforts and expenses that had been invested over the years in establishing those [seasoned] subscriber relationships." (Pet. App. at 43a.) Thus, the district court's conclusion that the government's experts "were unqualified, valued the wrong asset and utilized inappropriate methodology" (Pet. App. at 43a) is unassailable.

In sum, Ledger clearly demonstrated that the assets it sought to depreciate—the relationships with the 460,000 sub-

50 The stark difference between the two assets was demonstrated through hypothetical questions posed to one expert which highlighted the difference between the decreased price that would be paid if the list of subscribers were lost on the night before the transaction and the much lower price that would be paid if a catastrophic event annihilated all 460,000 subscribers that same evening. (J.A. at 128-31.)

51 Specifically, under the government experts' methodology, a marginal subscriber would be accorded the highest value based upon solicitation costs because it would require greater effort and inducements to secure his subscription when, in fact, he would be the least valuable subscriber because he would terminate his subscription quickly. By contrast, the seasoned subscriber would be accorded the lowest value based upon solicitation costs because his demand for the paper would be so great that he might subscribe without any solicitation and would not require inducements when, in fact, he would be the most valuable subscriber because he would remain a subscriber for a long period of time.

scribers acquired on May 31, 1977—were distinct from a mere list of subscribers, and it likewise demonstrated that the cost method was not appropriate for valuing the paid subscriber relationships. (Pet. App. at 42a-43a; J.A. at 67, 101, 102-04, 112, 121-23, 162, 165, 175-76.) The question remains, however, whether the use of the income method somehow converted an otherwise depreciable wasting asset into nondepreciable goodwill, as the Third Circuit effectively concluded.

B. The Income Method Was A Proper Method Of Valuation

Intangible assets are *normally* valued pursuant to the income method, for this is the method a willing buyer and willing seller would ordinarily apply in determining the asset's sales price. *See Colorado National*, 60 T.C.M. (CCH) at 792; *see also United States* v. *Ludey*, 274 U.S. 295, 301 (1927). There is no support for the Third Circuit's suggestion that the method of valuing an asset—in particular the use of the income method—is a threshold determinant of depreciability.[52] Many wasting assets, such as patents, are routinely and properly valued by reference to the income, or net economic benefit, they will produce over their limited life, not according to the cost of producing the invention. Where taxpayers have sought to establish the value of a wasting intangible asset pursuant to the income method, courts have consistently allowed such valuations.[53]

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52 Nor do the statute, the regulation, or the government's published revenue rulings provide any support for such a proposition. To the contrary, Congress recently recognized that the income method (or capitalized earnings method) is one of the "commonly accepted methods" of intangible asset valuation for purposes of determining the tax basis of assets in the context of the acquisition of an ongoing business. S. Rep. No. 99-313, 99th Cong. 2nd Sess. 252 (1986).

53 *See, e.g.*, *Donrey*, 809 F.2d 534; *Miami Valley Broadcasting Corp.* v. *United States*, 499 F.2d 677, 689 (Ct. Cl. 1974); *Western Mortgage Corp.* v. *United States*, 308 F. Supp. 333 (C.D. Calif. 1969); *Ithaca Industries, Inc.* v. *Commissioner*, 97 T.C. 253 (1991); *Citizens & Southern*, 91 T.C. 463; *Colorado National*, 60 T.C.M. (CCH) 771; *First Pennsylvania Banking*, 56 T.C. 677; *Manhattan Co. of Va.*, 50 T.C. 78; *Business Service Indus.*, 51 T.C.M. (CCH) 539.

Fundamentally, valuation methodology is an area in which the courts have routinely and properly relied upon experts and those who actually engage in real world transactions between willing buyers and willing sellers. Here, the unequivocal and uncontradicted testimony established, and the district court found, that the income approach "best reflects the method that buyers and sellers would utilize to determine the price at which such assets would change hands." (Pet. App. at 43a-44a.) That testimony and finding in no way undercuts the nature of the assets as having determinable lives and ascertainable values.

In the final analysis, the Third Circuit's conclusion that Ledger had not satisfied its burden of proving a value for its paid subscribers "separate and distinct from goodwill" (Pet. App. at 30a), is simply a restatement of its premise that the value of subscribers is in their continued patronage and, therefore, the subscribers are goodwill which cannot be depreciated. The fallacy in the Third Circuit's reasoning lies in its departure from the fundamental principle that assets with limited lives and ascertainable values are depreciable. The limited lives of the Booth newspapers' subscribers and the fact that they could be directly valued demonstrated conclusively the prerequisites for depreciability; the fact that the valuation method utilized was an income method rather than a cost method in no way detracts from those attributes of the subscribers that make them depreciable.

CONCLUSION

This Court should reverse the judgment below and reaffirm the uniformly accepted principle that an intangible asset that has a determinable useful life and a value distinct from goodwill is depreciable.

Respectfully submitted,

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